PIMS – Profit Impact of Market Strategy

The Profit Impact of Market Strategies (PIMS) is a comprehensive, long-term study of the performance of strategic business units (SBUs) in thousands of companies in all major industries. The PIMS project began at General Electric in the mid-1960s. It was continued at Harvard University in the early 1970s, then was taken over by the Strategic Planning Institute (SPI) in 1975. Since then, SPI researchers and consultants have continued working on the development and application of PIMS data.

According to the SPI, the PIMS database is "a collection of statistically documented experiences drawn from thousands of businesses, designed to help understand what kinds of strategies (e.g. quality, pricing, vertical integration, innovation, advertising) work best in what kinds of business environments. The data constitute a key resource for such critical management tasks as evaluating business performance, analyzing new business opportunities, evaluating and reality testing new strategies, and screening business portfolios."

The main function of PIMS is to highlight the relationship between a business's key strategic decisions and its results. Analyzed correctly, the data can help managers gain a better understanding of their business environment, identify critical factors in improving the position of their company, and develop strategies that will enable them to create a sustainable advantage. PIMS principles are taught in business schools, and the data are widely used in academic research. As a result, PIMS has influenced business strategy in companies around the world.

**The Pims Database**

The information comprising the PIMS database is drawn from member companies of SPI. These companies contribute profiles of their SBUs that include financial data as well as information on customers, markets, competitors, and operations. The SBUs in the database are separated into eight classifications: producers of [consumer durables](http://www.answers.com/topic/consumer-durables-1), consumer non-durables, capital goods, raw materials, components, or supplies; [wholesale](http://www.answers.com/topic/wholesale) and retail distributors; and providers of services. Specific companies and industries are not identified. Each SBU profile includes financial data from the income statement and balance sheet, as well as information about quality, price, new products, market share, and competitive tactics. "It tracks the standard financial measures, plus many of the marketing and strategy variables thought to drive financial performance," Hiram and Schewe explained in *The Portable MBA in Marketing.*

From this database of [SBU](http://www.answers.com/topic/sbu-abbreviation) experiences and results, SPI researchers developed a set of strategic principles and a methodology for examining business problems and opportunities. Users of the data can look for statistical relationships and compare the experiences of similar businesses, but cannot access the individual SBU data files. For small business owners, PIMS provides an opportunity to obtain information about competitors, markets, market shares, prices, and financial performance. This information enables small business owners to see how their strategies might play out in the market by comparing the experiences of similar businesses profiled in the PIMS database.

For example, the owner of a business that is a high-quality producer in a declining market might analyze the PIMS data to find out how various strategic initiatives affected the performance of other high-quality producers in declining markets. However, the PIMS data cannot provide information about specific companies—such as levels of debt and equity—or about overall industries. "The way to use PIMS effectively is not to simply run with the general findings," according to the SPI website. "Rather, analyze the experience of comparables by 1) profiling the specific business situation and identifying the key issues, and then 2) accessing and analyzing the experience of a sample of PIMS businesses situationally comparable to this business."

**Further Reading:**

Hagerty, Michael R., James M. Carman, and Gary J. Russell. "Estimating Elasticities with PIMS Data." *Journal of Marketing Research.* February 1988.

Hiam, Alexander, and Charles D. Schewe. *The Portable MBA in Marketing.* John Wiley, 1992.

"The PIMS Database." Strategic Planning Institute. [http://www.thespinet.org](http://www.thespinet.org/).

Read more: <http://www.answers.com/topic/profit-impact-of-market-strategies-pims#ixzz1G9EbhdDT>

In 1960, the vice president of marketing services at GE authorized a large-scale project (called PROM, for profitability optimization model) to examine the profit impact of marketing strategies. Several years of effort produced a computer-based model that identified the major factors responsible for a great deal of the variation in return on investment. Because the data used to support the model came from diverse markets and industries, the PROM model is often referred to as a crosssectional model. Even today, cross-sectional models are popularly used at GE. In 1972, the PROM program, henceforth called PIMS, was moved to the Marketing Science Institute, a nonprofit organization associated with the Harvard Business School. The scope of the PIMS program has increased so much and its popularity has gained such momentum that a few years ago its administration moved to the Strategic Planning Institute, a new organization established for PIMS. The PIMS program is based on the experience of more than 500 companies in nearly 3,800 “businesses” for periods that range from two to twelve years. “Business” is synonymous with “SBU” and is defined as an operative unit that sells a distinct set of products to an identifiable group of customers in competition with a well-defined set of competitors. Essentially, PIMS is a cross-sectional study of the strategic experience of profit organizations. The information gathered from participating businesses is supplied to the PIMS program in a standardized format in the form of about 200 pieces of data. The PIMS database covers large and small companies; markets in North America, Europe, and elsewhere; and a wide variety of products and services, ranging from candy to heavy capital goods to financial services. The information deals with such items as

• A description of the market conditions in which the business operates, including such things as the distribution channels used by the SBU, the number and size of its customers, and rates of market growth and inflation.

• The business unit’s competitive position in its marketplace, including marketshare, relative quality, prices and costs relative to the competition, and degree ofvertical integration relative to the competition.

• Annual measures of the SBU’s financial and operating performance over periodsranging from two to twelve years.

***Overall Results*** The PIMS project indicated that the profitability of a business is affected by 37 basic factors, explaining the more than 80 percent profitability variation among businesses studied. Of the 37 basic factors, seven proved to be of primary importance. Based on analysis of information available in the PIMS database, Buzzell and Gale have hypothesized the following strategy principles, or links between strategy and performance:

1. In the long run, the most important single factor affecting a business unit’s performance is the quality of its products and services relative to those of competitors. A quality edge boosts performance in two ways. In the short run, superior quality yields increased profits via premium prices. In the longer term, superior or improving relative quality is the more effective way for a business to grow, leading to both market expansion and gains in market share.

2. Market share and profitability are strongly related. Business units with very large shares over 50 percent of their served markets enjoy rates of return more than three times greater than small-share SBUs (those that serve under 10 percent of their markets). The primary reason for the market share-profitability link, apart from the connection with relative quality, is that large-share businesses benefit from scale economies. They simply have lower per-unit costs than their smaller competitors.

3. High-investment intensity acts as a powerful drag on profitability. Investmentintensive businesses are those that employ a great deal of capital per dollar of sales, per dollar of value added, or per employee.

4. Many so-called “dog” and “question mark” businesses generate cash, while many “cash cows” are dry. The guiding principle of the growth-share matrix approach to planning (see Article 10) is that cash flows largely depend on market growth and competitive position (your share relative to that of your largest competitor). However, the PIMS-based research shows that, while market growth and relative share are linked to cash flows, many other factors also influence this dimension of performance. As a result, forecasts of cash flow based solely on the growth-share matrix are often misleading.

5. Vertical integration is a profitable strategy for some kinds of businesses, but not for others. Whether increased vertical integration helps or hurts depends on the situation, quite apart from the question of the cost of achieving it.

6. Most of the strategic factors that boost ROI also contribute to long-term value. These principles are derived from the premise that business performance depends on three major kinds of factors: the characteristics of the market (i.e., market differentiation, market growth rate, entry conditions, unionization, capital intensity, and purchase amount), the business’s competitive position in that market (i.e., relative perceived quality, relative market share, relative capital intensity, and relative cost), and the strategy it follows (i.e., pricing, research and development spending, new product introductions, change in relative quality, variety of products/services, marketing expenses, distribution channels, and relative vertical integration). Performance refers to such measures as profitability (ROS, ROI, etc.), growth, cash flow, value enhancement, and stock prices.

***Managerial Applications*** The PIMS approach is to gather data on as many actual business experiences as possible and to search for relationships that appear to have the most significant effect on performance. Amodel of these relationships is then developed so that an estimate of a business’s return on investment can be made from the structural competitive/strategy factors associated with the business. Obviously, the PIMS conceptual framework must be modified on occasion. For example, repositioning structural factors may be impossible and the costs of doing so prohibitive. Besides, actual performance may reflect some element of luck or some unusual event. In addition, results may be influenced by the transitional effect of a conscious change in strategic direction. Despite these reservations, the PIMS framework can be beneficial in the following ways:

1. It provides a realistic and consistent method for establishing potential return levels for individual businesses.

2. It stimulates managerial thinking on the reasons for deviations from par performance.

3. It provides insight into strategic moves that will improve the par return on investment.

4. It encourages a more discerning appraisal of business unit performance. Since the mid-1970s, the PIMS database has been used by managers and planning specialists in many ways. Applications include developing business plans, evaluating forecasts submitted by divisional managers, and appraising possible strategies. The data suggests that

• For followers, current profitability is adversely affected by a high level of product innovation, measured either by the ratio of new product sales to total sales or by research and development spending. The penalty paid for innovation is especially heavy for businesses ranked fourth or lower in their served markets. The market leader’s profitability, on the other hand, is not hurt by new product activity or research and development spending.

• High rates of marketing expenditure depress return on investment for followers, not for leaders.

• Low-ranking market followers benefit from high inflation. For businesses ranked first, second, and third, inflation has no relation to return on investment.

**MEASURING THE VALUE OF MARKETING STRATEGIES** In the last few years, a new yardstick for measuring the worth of marketing strategies has been suggested. This new approach, called **value-based planning**, judges marketing strategies by their ability to enhance shareholders’ value. It emphasizes the impact a strategic move has on the *value* investors place on the equity portion of a firm’s assets. The principal feature of value-based planning is that managers should be evaluated on their ability to make strategic investments that produce returns greater than their cost of capital. Value-based planning draws ideas from contemporary financial theory. For example, a company’s primary obligation is to maximize returns from capital appreciation. Similarly, the market value of a stock depends on investors’ expectations of the ability of each business unit in the firm to generate cash. Value is created when the financial benefits of a strategic activity exceed costs. To account for differences in the timing and riskiness of the costs and benefits, value-based planning estimates overall value by discounting all relevant cash flows. Acompany that has been using the value-based approach for some time is the Connecticut-based Dexter Corporation. Its value-based planning uses four subsystems:

• The Dexter financial decision support system (DSS), which provides strategic business segments (SBS) with financial data. The DSS provides a monthly profit and loss and balance sheet statement of each strategic business segment. All divisional expenses, assets, and current liabilities are allocated to the SBSs.

• A microcomputer-based system, which transforms this data for use in the two following subsystems: corporate financial reports system and value planner system. The financial data generated by DSS must be transformed to fit the input specifications of these two subsystems.

• The corporate financial reports system estimates the cost of capital of an SBS. For estimating cost of capital, Dexter uses two models. The first is the bond-rating simulation model. This model is used to estimate the capital structure appropriate to each of its SBSs, given its six-year financial history. Each SBS is assigned the highest debt-to-total capital ratio that would allow it to receive an A bond rating. The second model, which is used to compute cost of capital, is the business risk index estimation model. This model allows cost of equity to be estimated for business segments that are not publicly traded.

• The value planner system estimates a business’s future cash flows. The basic premise of the value planner system is that business decisions should be based on a rigorous consideration of expected future cash flows. Dexter uses the 12 most recent quarters of SBS data to produce a first-cut projection of future cash flows. As information on a new quarter becomes available, the oldest quarter in the model is deleted. These historical trends are used for projecting financial ratios into the future. The following assumptions are made to compute future cash flows: **Sales growth** Based on the expectation that each SBS will maintain market share. **Net plant investment** Based on the growth rate in unit volume deemed necessary to maintain Dexter’s market share.

**Unallocated divisional expenses** Projected for each SBS using the same percentageof sales used for the division as a whole.**The appropriate time horizon for cash flow projections** Based on theexpected number of years that a business can reinvest at an expected rate ofreturn. These assumptions are controversial because they do not allow cash flow projectionsto be tailored to each SBS. Dexter management terms its historical forecast a*naive* projection and uses it to challenge its managers to explain why the futurewill be different from the recent past.The next step in the value-based planning process is to compute the value ofprojected future cash flows and to discount them by the cost of capital for an SBS.If the estimated value of an SBS is in excess of its article value, the SBS contributespositively to the wealth of Dexter’s stockholders, which means it makes sense toreinvest in it. The major strengths of Dexter’s SBS value planner system have been articulatedas follows:

• **Its emphasis on being intelligible to line managers** Avalue-based planningmodel can indicate which SBSs are not creating value for the firm’s stockholders.However, it is the SBS manager who must initiate action to rectify problems thatthe analysis uncovers.

• **Its degree of accuracy** The real dilemma in designing models for value-basedplanning is to make them easy to use while improving the accuracy with whichthey reflect or predict the firm’s market value.

• **Its integration with existing systems and databases** By developing a systemthat works with existing systems, costs are reduced and upgrades are easier toimplement. Also, it is easier to gain the acceptance of line managers if the valuebasedplanning system is presented as an extension of the decision support systemthey are currently using. In the seven years that Dexter has used the value-based approach, it has madeimportant contributions to the decision-making process. Using this approach,Dexter managers made the following decisions:

• Not to invest further in an SBS with high-growth prospects until its valuation,based on actual performance, increases significantly.

• To harvest and downsize an SBS with a negative value.

• To sell an SBS with negative value to its employees for article value.

• To sell an SBS with a value higher than article value but for which an offer wasreceived that was significantly greater than any valuation that could be reasonablymodeled in Dexter’s hands.The interesting characteristic of these decisions is that they can run somewhatcounter to the prescriptions that flow out of a typical portfolio-planningapproach. The first decision, for example, refers to a star business, presumablyworthy of further investment. Unlike portfolio planning, in which growth isdesirable in and of itself, under value-based planning, growth is healthy only ifthe business is creating value.Dexter uses value-based planning as a guideline for decision making, not asan absolute rule. The approach is, in general, understood and accepted, but manymanagers question its relevance. They now know whether their divisions createvalue for the company, but they do not understand how they can use that informationto make or change important business decisions. Top management understandsthat value-added planning needs more time before it is completelyaccepted.